Canada
Tax

R&D Tax Update

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Budget 2012: new R&D support measures challenge Canada's global position

Innovation is one of the most important contributors to persistent and sustained economic growth and a key solution to Canada's lagging productivity, as discussed in Deloitte's **The future of productivity: An eight-step game plan for Canada**. There is broad recognition that government support of innovation is critical to ensuring that Canada remains a leading global destination for innovative businesses.

In anticipation of the 2012 federal budget, important issues such as Canada's productivity and innovation gap, tax credits versus direct grants, consultants' fees, effectiveness of the Scientific Research and Experimental Development (SR&ED) program, appointing a new minister of innovation, and improving administration of incentives have all been the subject of much debate.

All stakeholders agree that it is critical for government policies to both retain existing innovators and attract additional foreign research and development (R&D) investment in Canada.

So what did the government do?

Proposed changes to innovation support in Canada

The recommendations contained in the budget were based on the October 17, 2011 report prepared by the expert panel (Jenkins report) tasked with reviewing federal support for R&D. The following table outlines the key recommendations from the Jenkins report and how Budget 2012 implements them:

Jenkins report recommendations	Budget 2012 proposals	Estimated economic or budgetary impact
Create the Industrial Research and Innovation Council with clear business innovation mandate	• Double support for companies through Industrial Research Assistance Program (IRAP) • Launch the Western Innovation Program (similar to such programs in other provinces)	• IRAP is increased by $110M annually

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Simplify the SR&ED program	• Reduce the 20% SR&ED investment tax credit rate to 15% for taxation years ending after 2013. However, no change to the enhanced 35% credit for eligible Canadian controlled private corporations. • Exclude capital expenditures from SR&ED deductions and investment tax credits for property acquired after 2013 • Reduce the prescribed proxy amount from 65% to 60% for 2013 and to 55% for years after 2013 • Limit qualifying expenditures to arm's length contractors to 80% of the contract payment for expenditures incurred after December 31, 2012 • Exclude from the payer's qualifying expenditures incurred after December 31, 2013, any amount that an arm's length contractor has paid in respect of a capital expenditure made to fulfill the contract • Conduct a pilot project to determine the viability of a formal pre-approval process • Enhance the existing online self-assessment eligibility tool • Make more frequent and effective use of "tax alerts" • Improve the Notice of Objection process to allow for a second review of scientific eligibility determinations	• Savings of $295M annually • Savings of $40M annually • Savings of $100M annually • Savings of $65M annually
Increase government procurement	• Make the Canadian Innovation Commercialization Program permanent • Add a military procurement component	• Additional investment of $95M over 3 years and $40M subsequently
Refocus the National Research Council (NRC)	• Provide support in 2012-13 to the NRC to refocus on business-led, industry-relevant research • Double the IRAP Internship program • Make the Business-Led Networks of Centres of Excellence program permanent • Support the continued enhancement of the forestry sector	• One time increase of $67M • $14M over 2 years • $12M annually • $105M over 2 years
Establish new risk capital fund to support start-up and later stage companies	• Increase private sector investment in early-stage risk capital and support the creation of large-scale venture capital funds • Confirm the commitment to increase Business Development Bank of Canada budget	• $400M available • $100M
Appoint a federal minister of innovation	• Not addressed in budget.	

The government announced that further actions will be implemented in response to the Expert panel's recommendations in the coming months and in Budget 2013. In addition, the government committed to working with industry representatives to address emerging issues.

Global context

In 2008, the Organisation for Economic Co-operation and Development (OECD) ranked Canada's R&D tax incentive regime for small businesses third behind that of France and Ireland and ninth for our incentives for large business. However, since 2008 many countries are making significant improvements to their programs rather than scaling back their incentive regimes, thereby lowering their effective cost of doing research, as discussed in our **Global Survey of R&D Tax Incentives**. In fact, twelve out of the 24 top economies have enhanced their R&D incentive regimes during the most recent economic downturn. Some examples of the most recent changes include:

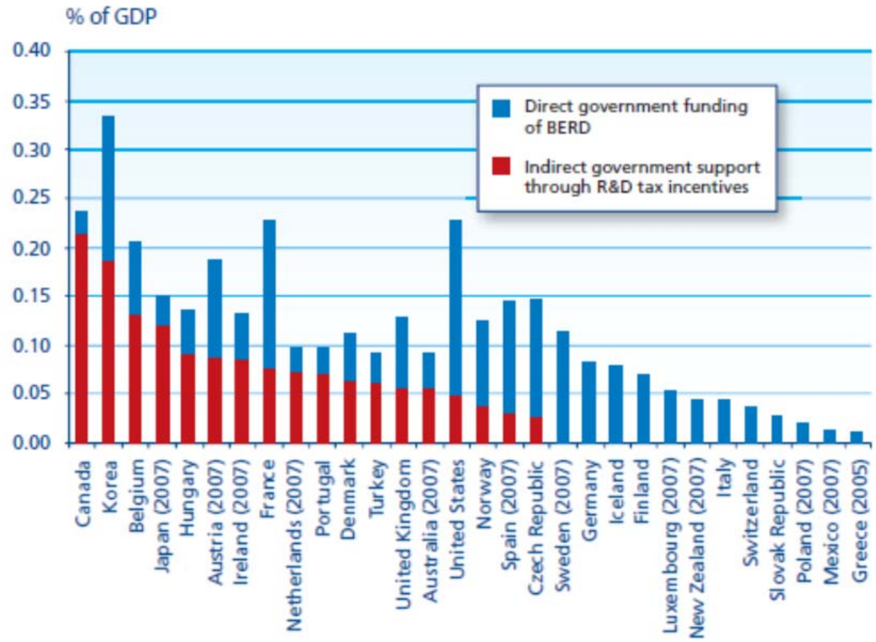
- Increased credit or deduction percentages (Australia, China, Ireland, Italy, Japan, Russia, Singapore, Netherlands);
- New or enhanced carryback and/or carryforward provisions (France, Ireland, Japan);
- Refundable credits (France, Australia, Ireland, United Kingdom);
- "Patent box" – deductions for gross patent income (Belgium, United Kingdom); and
- More countries are considering introducing R&D tax credits

With the above-noted proposed changes to the SR&ED tax credit program, Canada's R&D tax incentive regime will be less attractive to foreign investment as the effective cost of doing research in Canada has now increased. Even without considering the improvements made by other countries, Canada's R&D tax incentive regime for large businesses would no longer be ranked as one of the top ten in the world.

Shifting from direct to indirect support for innovation

As shown in the chart below, Canada currently uses mainly indirect support through tax incentives. Industry has commented on its preference for such a universal program, allowing companies to make investment decisions. Budget 2012 proposed shift to direct funding is therefore likely be perceived as an infringement on market choices. In our view, Canada should have broad-based tax incentives for all industries and these should be complemented by grants aimed at supporting specific priorities.

Direct and Indirect Government Support for R&D, 2008 (except where noted)



Note: The data in this figure do not include R&D tax incentives provided by sub-national governments.

Source: OECD Science and Technology Scoreboard 2010 & Innovation Canada: A Call to Action (2011)

Further consultation with industry is urged

The federal government's support for innovation through the SR&ED incentive program is critical to Canada's global competitiveness. We believe that any changes to the program should only be made after full consultation with industry and other key stakeholders, both domestic and foreign. In fact, the United Kingdom has taken this approach in its proposal for an "above the line" credit for R&D. Consultation is key to avoiding a misstep today that could cause a massive loss of high-value employment and investment in Canada in the future.

More than ever…

More than ever, companies must understand how their innovation investments are impacted by the new rules. It will be important to understand the details of R&D activities being undertaken and the impact of the technical intricacies of the proposals in order to assess their specific financial impact.

Large multinationals have become more sophisticated in organizing innovation investment globally. As Canada falls out of the top 10 in innovation support for large business, keeping Canada attractive to R&D investors has become the new challenge for government, business and advisors.

Deloitte professionals are continuing their analysis of the detailed measures and are available to discuss them with you. We remain committed to pursuing dialogue with all relevant stakeholders in order to ensure that Canada is regarded as a global innovation leader.

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